

# PERS UNFUNDED LIABILITY

A Report Prepared for the  
Legislative Finance Committee

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September 17, 2003

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# **PERS UNFUNDED LIABILITY**

## **INTRODUCTION**

The purpose of this report is to inform the Legislative Finance Committee of impacts from employer contribution increases that would likely be requested to keep the Public Employee Retirement System (PERS) actuarially sound. Recent reports by the actuary under contract to PERS indicate that recent investment losses have eroded system funding below the fully funded level. Although a formal decision by the Public Employee's Retirement Board has not been made, contribution increases may be requested to offset the funding impacts of investment losses sustained since fiscal 2001. This report begins with an overview of the Montana Constitution and other statutory requirements for the retirement system. It then summarizes the financial status of the Public Employee Retirement System, focusing on the defined benefit plan portion of the system. Finally, it estimates the fiscal impacts to fund increases in contributions to the system.

## **THE PUBLIC EMPLOYEE RETIREMENT SYSTEM**

The Public Employee's Retirement System (PERS) is comprised of two of ten separate retirement plans administered by the Public Employee's Retirement Board (PERB). Beginning in July 2002, PERS was separated into a defined benefit plan and a defined contribution plan. The following differentiates a defined benefit plan from a defined contribution plan:

- In a defined benefit plan, the retirement benefits paid out of the plan are controlled by formula and the plan sponsor (employer) controls the administration of the plan and assumes the investment risk
- In a defined contribution plan, the member controls the level of contributions and makes the investment decisions, but also assumes the investment risk

Requirements for the public retirement systems are contained in the Constitution of Montana and Title 19, MCA, with Chapter 3 dedicated to the Public Employee Retirement System, as follows:

- The Constitution of Montana requires that the public retirement systems be funded on an actuarially sound basis<sup>1</sup>
- The current statutory employer contribution rate (the state share) is 6.9 percent of employer's covered payroll and applies to both defined benefit and defined contribution plan members
- The state also contributes 0.1 percent of the compensation of members employed by local government entities and school districts with funding from the state general fund
- The employee contribution rate for the defined benefit plan is specified in statute to be 6.9 percent of the member's compensation

Figure 1 shows the historical employer contribution rates from the beginning of the defined benefit plan up to the current rate of 6.9 percent of employer's covered payroll. The figure shows that as the plan has matured, the employer contribution rates have gradually increased to fund the plan on an actuarial basis. The figure also shows that changes in the member contributions and employer contributions have not always coincided.

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<sup>1</sup> Article VIII, Section 15, Constitution of Montana.

Actuarially sound basis means contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years.

# FINANCIAL CONDITION OF PERS TRUST FUND

## Investment Losses Have Eroded Reserves

Historically, PERS trust fund investments have realized earnings at rates above the rate assumed in actuarial projections for the fund. These higher-than-anticipated returns helped keep PERS on an actuarially sound footing. However, beginning in fiscal 2001 and continuing through much of fiscal 2003, investment returns have been negative or well below the rates assumed in actuarial estimates. The financial statements for PERS show investment losses of \$148.5 million in fiscal 2001 and \$201.4 million in fiscal 2002. According to the Montana Public Employee Retirement Administration (MPERA) staff, fiscal 2003 earnings showed signs of improvement, but will likely fall short of the 8 percent rate used in actuarial projections and valuations. The most recent projections made by the consultant actuary indicate that the deferred investment losses of fiscal years 2001 and 2002 have eroded reserves to the point where the PERS defined benefit plan has reserves below the level needed to pay unfunded liabilities of the plan and is no longer actuarially funded.

**Figure 1**  
**Public Employee Retirement System**  
**Contribution Rates**

Effective Date	Member	Employer
	% of Compensation	% of Payroll
July 1, 1973	5.750	4.600
July 1, 1975	6.000	4.900
July 1, 1976	6.000	5.250
July 1, 1977	6.000	5.650
July 1, 1978	6.000	5.900
July 1, 1981	6.000	6.320
July 1, 1983	6.000	6.417
July 1, 1985	6.000	6.417
July 1, 1989	6.150	6.417
July 1, 1990	6.300	6.417
July 1, 1991	6.417	6.417
July 1, 1992	6.550	6.550
July 1, 1993	6.700	6.700
July 1, 1997	6.700	6.800
July 1, 1999	6.900	6.900

## What Does This Mean?

Montana law requires that a biennial actuarial valuation be conducted for the Public Retirement System. The last valuation was completed as of July 1, 2002. The next valuation will be based on data as of July 1, 2004. After the valuation is completed and documented in Fall 2004, the PERB will make a determination of any rate increases it will request during the 2005 legislature. At present, the board has made no specific decisions on the course of action it will recommend.

Since the basic premise of a defined benefit plan is that the plan sponsor assumes the investment risk, any rate increase would be funded through the employer contributions and not member contributions. The primary factor for determining that the member contributions would not increase rests with the fact that the contribution increase would not result in additional benefits for plan members, but are needed to offset investment losses of the fund resulting from plan management actions. In contrast, the defined contribution plan allows the members to control the level of their contributions and the investment mix of their contributions. In the defined contribution plan, the member assumes the investment risk but also would benefit from high investment returns. Therefore, the potential exists that the increase would apply to the employer contribution for members in the defined benefit only.

At this time, a determination has not been made as to what the contribution rate should be to fully fund the plan. Investment history and expectations of future investment returns factor into the determination as they are used in the actuarial valuation due in Fall 2004. Also, the approach taken to amortize the unfunded liability caused by the deferred investment losses will make a difference in the rate request, since the plan contribution rate could be increased in one increment or it could be gradually increased

over time. It goes without saying that a single increment contribution rate increase would more aggressively offset the deferred investment losses, but would result in larger immediate costs to government entities.

## Fiscal Impacts of Employer Rate Changes

Based on fiscal 2003 employer contributions for employee retirement, Figure 2 shows the estimated impacts by major funding source from a 1.0 percent rate increase (increasing the state share from 6.9 to 7.9 percent of payroll). The figure shows that for each 1.0 percent increase in covered payroll contributions to retirement, general fund obligation would increase by nearly \$1.8 million per year and funding from all state sources would increase by \$5.5 million per year. Based on early projections by the actuary, the employer contribution may need to be increased by several percent of payroll to amortize the deferred investment losses over 30 years. If the employee contribution increased from 6.9 percent to 8.9 percent of covered payroll, the general fund support for retirement would increase by about \$3.5 million per year.

## Other Retirement Plans not Actuarially Sound

In addition to PERS defined benefit plan, Game Wardens' and Peace Officers' Retirement System (GWPORS) and the Sheriffs' Retirement System (SRS) are not actuarially funded. The GWPORS was noted in the most recent legislative financial-compliance audit as not being actuarially funded. The SRS was not noted in the audit, but has subsequently been identified by the actuary as being under-funded if investment losses that were deferred in the 2002 actuarial valuation are considered. The GWPORS had fiscal 2003 contributions from a 9.0 percent of participating payroll employer rate of \$1.8 million. Likewise, SRS had fiscal 2003 contributions from a 9.535 percent of participating payroll employer rate of \$2.5 million. Because of the relatively small size of these two retirement plans and the fact that non-state government entities pay a portion of employer contributions, impacts on state funds will be much less than will be seen from changes in the PERS employer contribution rate. The above information is intended to identify a potential impact on state funding for the GWPORS and SRS. Specific information is not available to more accurately estimate the state funding impacts.

## CONCLUSION

Recent investment losses have reduced PERS defined benefit plan reserves below the level needed to fund plan liabilities on an actuarially sound basis. Contribution increases will likely be needed to offset the funding deficit to fully fund the plan on an actuarial basis, as required in the Constitution of Montana. Because the additional funding is needed to restore the plan to a fully funded level and will not add benefits for plan members, the source of the funding can not come from member contributions. As such, employer contributions will need to increase to offset the funding deficit. For each 1.0 percent increase in covered payroll contributed to the plan, the funding from state sources would increase by

**Figure 2**  
**Impacts of State Contribution Changes**  
**Funding per 1.0 Percent Rate Change**  
(\$ millions)

Funding	Fiscal 2003	Per 1.0% Change
General fund	\$12.1	\$1.8
State special revenue	12.1	1.7
Federal special revenue	4.9	0.7
Proprietary	2.9	0.4
All other	5.7	0.8
Total	<u>\$37.7</u>	<u>\$5.5</u>

Based on fiscal 2003 state expenditures for accounting code 61402 (retirement), which includes contributions to all retirement plans. Contributions to PERS comprises nearly 99 percent of the contributions, but funding of contributions by retirement plan is not determinable from the data. Therefore, the estimate of impacts shown on the figure are slightly conservative.

\$5.5 million per year, of which \$1.8 million would come from the general fund. As much as a 2.0 percent increase may be needed based on preliminary information.

This information is provided as an advance warning to the legislature of a potential general fund liability, since the Public Employee Retirement Board has not made a determination to seek a rate increase or the magnitude of any rate increase it would request. Since any decision of the board would be made based on an actuarial valuation after the accounting records for fiscal 2004 have closed, a decision is not expected until Fall 2004.

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